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An Insight of The Evolution of Financial Frauds In India

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Abstract

India is a major concern for the global community. The introduction, growth and utilization of information and telecommunication technologies have been accompanied by an increase in illegal activities. With respect to cyberspace, anonymous servers, hijacked emails and fake websites are being used as a tool and medium for fraud by cyber scammers. Indian fraud on the Internet is an obvious form of cybercrime that has been affected by the global revolution. This form of crimes is not exclusive to large sums of money to participate into business proposals but also covers romance, lottery and charity scams. Estimates of the total losses due to this scam vary widely. Thus, there is a need for international cooperation to stamp out such illicit activities and protect Internet users. Although new techniques are constantly being implemented and regulations being adopted to combat and eradicate diverse forms of fraud, yet cyberspace is also providing new means and tools that facilitate committing these scams. Accordingly, this paper seeks to address and analyse some issues related to the use of cyberspace for fraud by cyber scammers especially Financial Fraud and the techniques used. It will also provide an analysis of the existing legislative and regulatory framework and their efficiency in combating this form of cross-border crime taking India as a case study. This paper presents the historical origin of financial frauds and presents a small survey of some

popular financial frauds committed in the recent years in India and ways to prevent frauds from happening.

1 What is Financial Fraud?

Financial fraud is a situation in which the legal and ethical management of financial resources does not take place. In most countries around the world, this type of fraud occurs due to deliberate decisions and actions made by people who handle money and other assets on behalf of employers or clients. However, there are a few places around the world where the unintentional mishandling of funds is also classified as fraud and is subject to the same legal censure as any deliberate action.

In most cases, the fraudulent handling of financial resources will lead to substantial losses for an investor or a corporation. The financial loss is sometimes carefully hidden in the accounting records that are used to track activity involving the resources, allowing it to continue until a great deal of money and other assets are siphoned off and no longer in the control of the owner. Business fraud of this type may be conducted by any company officer or employee who has access to corporate resources, and may continue for an extended length of time before becoming apparent.

2 Types of Financial Fraud

1) Misappropriation of income or assets
2) Fictitious relative
3) Identity theft
4) Financial institution employee fraud
5) Financial institution examiner fraud
6) Power of Attorney fraud.
7) Charitable donation scam

8) Advance fee fraud or “419” fraud
9) Pigeon drop
10) Inheritance scams
11) International lottery fraud
12) Telemarketing scams
13) Fake prizes
14) Internet sales or online auction fraud
15) Government grant scams
16) Phishing
17) Spoofing
18) Pharming
19) top Foreclosure Scam
20) Investment Property

3 History record of Financial Fraud in India

Worldwide we consider Sherlock Holmes to be the first Forensic accountant; however the contribution of some of the scholars from ancient India cannot be ignored. In India Kautilya was the first person to mention the forty ways of embezzlement in his famous Kautilya’sArthashastra during the ancient Mauryan Times (321-296 BC).“There are about forty ways of embezzlement: what is realised earlier is entered later on; what is realised later is entered earlier; what ought to be realised is not realised; what is hard to realise is shown as realised; what is collected is shown as not collected; what has not been collected is shown as collected; what is collected in part is entered as collected in full; what is collected in full is entered as collected in part; what is collected is of one sort, while what is entered is of another sort; what is realised from one source is shown as realised from another; what is payable is not paid; what is not payable is paid; not paid in time; paid untimely; small gifts made large gifts; large gifts made small gifts; what is gifted is of one sort while what is entered is of another; the real done is one while the person entered (in the register) as done is another; what has been taken into (the treasury) is removed while what has not been credited to it is shown as credited; raw materials that are not paid for are entered, while those that are paid for are not entered; an aggregate is scattered in pieces; scattered items are converted into an aggregate; commodities of greater value are bartered for those of small value; what is of smaller value is bartered for one of greater value; price of commodities enhanced; price of commodities lowered; number of nights increased; number of nights decreased; the year not in harmony with its months; the month not in harmony with its days; inconsistency in the transactions carried on with personal supervision (samágamavishánah); misrepresentation of the source of income; inconsistency in giving charities; incongruity in representing the work turned out; inconsistency in dealing with fixed items; misrepresentation of test marks or the standard of fineness (of gold and silver); misrepresentation of prices of commodities; making use of false weight and measures; deception in counting articles; and making use of false cubic measures such as bhájan - these are the several ways of embezzlement."

4 <u>Financial Fraud in Modern days</u>

With white-collar crime almost doubling from 2009, financial fraud by insiders remains the single greatest fear of Indian companies, according to the results of a survey by audit and consulting firm KPMG. Of the 1,000 companies covered in the survey, 87% said they had incurred losses of at least Rs10 lakh due to fraud in 2009.The previous survey, carried out in 2008, had only 47% complaining on this count. At least 75% of Indian firms said instances of fraud had increased over the past two years.

A lack of objective and independent internal audits, inadequate overseeing of senior management's activities by the audit committee, and weak regulatory environment were pinpointed as culprits for the spike in financial statement frauds. The 10th biennial India Fraud Survey Report 2010reveals that 81% of the companies surveyed felt that financial statement fraud was the biggest threat in India, with at least 60% of them saying inadequate enforcement of regulations had increased such fraud. The findings of the report suggested that weak internal control systems, eroding ethical values and lack of legal action against fraudsters created an environment conducive to such crimes. The survey, conducted by KPMG's forensic wing in India, covered leading Indian firms from the public and private sectors. The respondents included chairman and managing directors, chief operating officers, chief financial officers, internal auditors, heads of investigation divisions and other senior management officials. Indian companies, according to the study, remained highly vulnerable to fraud in the absence of "inadequate internal control framework" that can identify and deal with such crimes. The report suggested that 41% of Indian firms did not have fraud risk management systems. The KPMG report showed that 45% of the firms had experienced fraudulent activities in the past two years, with financial services and consumer markets showing the highest levels of risk.But more than the lack of monitoring systems, what was prevalent and disturbing was the reluctance of companies to report incidence of frauds. According to the survey, only 35% of the companies initiated legal action against a perpetrator of fraud. A majority of the frauds had been investigated internally. Financial fraud is a situation in which the legal and ethical management of financial resources does not take place. In most countries around the world, this type of fraud occurs due to deliberate decisions and actions made by people who handle money and other assets on behalf of employers or clients. However, there are a few places around the world where the unintentional mishandling of funds was also classified as fraud and is subject to the same legal censure as any deliberate action.

India is increasingly becoming a Victim of Online Financial Fraud. Internationally known provider of computer security solutions Symantec Corporation said on October 10, 2007 that India was another country rapidly participating in financial fraud on the Internet and has was also becoming a victim of it. Such online financial fraud in India has increased by 81% during the last few months. According to the Internet Security Threat Report of the company that was published towards September end 2007. India occupies the 14th position globally in hosting phishing sites. The city of Mumbai accounted for 30% of all phishing Websites in the country, Delhi for 29%, and Chennai and Bangalore hosted 12% each of all phishing Websites. In the online food chain fraud, India has a major involvement where 33 Websites have been turned into phishing sites. These sites leveraged attacks to allow identity theft in 2006, Vishal Dhupar, Managing Director of Symantec, India told reporters. The Economic Times published this in news on October 10, 2007.So far in 2007, there hasn't been any significant virus outbreak following hackers' shift to making fortunes than acquiring fame in the cyber world. And these attackers have been targeting more of home PCs. In 2006, about 86% of home PCs were under attack in the cities of Mumbai, Bangalore and Delhi. With a rapid growth and speed of Internet bandwidth, nearly 59% of home PC users in India used technologies like network sharing, and online socializing and playing.

According to Symantec, cyber criminals are increasingly targeting victims by taking advantage of trusted environments. Symantec's study mentioned that India was sixth in the global ranking of countries for computers having multiple infections. Incidentally, the top most rank goes to USA. China also placed itself among the top countries with malicious activity, top countries suffering DoS (Denial of Service) outbreaks, countries with bot-infected PCs, countries as origin of attacks, and countries with multi-infectious computers. Cyber criminals who sell stolen data do so using underground servers. Such data include identification details like Social Security numbers, bank cards, credit cards, PINs, e-mail addresses and user accounts.

Security scams and financial scandals have lead to the manipulation of large amount of money, stock market and Sensex. Even the financial markets having regulatory authority and empowered legal sections have failed in providing good corporate governance to some extent.

The Securities Scam of 1992 **:-**The securities scam of 1992 was the mother of all Indian financial scandals. It exposed the utter lawlessness and absence of supervision in the money markets; it allowed funds to be transferred with impunity from banks and corporate houses into the equity markets and saw thousands of crores of bank funds to move in and out of brokers' bank accounts in what was later claimed as a "accepted market practice". A Special Court under a separate act of parliament was set up and over 70 cases were filed by the Central Bureau of Investigation of India but not a single scam has been finally convicted by the excruciatingly slow judicial system. Instead, their repeated attempts to re-enter the market with the same bag of tricks have caused further losses to investors. More significantly, the Reserve Bank of India which was guilty of gross negligence and was discovered to have deliberately buried supervision reports was let off free.

The IPO Scam (1993-1996) **:-**The entry of foreign institutional investors led to a massive bull run which saw secondary market recover from the scam even though stock trading was banned. Soon thereafter, the Control over Capital Issues Act was abolished with a one-line order and it opened the floodgates for a massive scam in the primary market (or Initial public offerings). This scam had two parts – the first was perpetrated by existing companies which ramped up their prices in order to raise money at hugely inflated premium to fund green field projects and mindless diversifications, most of which have either failed to take off or are languishing. The other half of the scam had a multitude of small traders, chartered accountants and businessmen, who teamed up with bankers and investment bankers to float new companies and raise public funds. The botched up M. S. Shoes case, exemplifies the first type of scam while the second type, which caused losses of several thousand crores of rupees was known as the 'vanishing companies' scandal. The IPO bubble which lasted three years from 1993 to96 finally burst when prices of listed companies began to crash. So huge was investors' disappointment that the primary market remained dead for the next two years, almost until the beginning of 1999.

CRB Scam (1996):-In 1996, Mr.Chain Kumar Bhansali, Chairman of CRB Capital markets Ltd was accused of taking off Rs.12 billion in the CRB scam. CRB was accused of using its State bank of India's accounts to siphon off the bank funds by encashing interest warrants and refund warrants. Millions of investors lost through fixed deposits and mutual funds. The Unit trust of India and Gujarat government also incurred heavy losses.

ITC-Chitalia: Foreign Exchange Regulation Act (FERA) violation act: (1996) :-The FERA violation was estimated around $80 million. In June 1996, enforcement directorate (ED) started FERA investigation of export transaction between ITC and Chitalia group of companies (EST Fibres) for the period of 1990-1995.The Chitalias and several directors of the company including ITC Chairman Mr.K.K.Chaugh were arrested and later released on bail. Later, ITC filed a suit on Chitalias for $15 million. Chitalias on the other hand, sued it for $ 55 million claiming ITC owed them.

Mutual Funds disaster:(1998-99) :- The biggest post liberalisation joke on investors was the suggestion that small investors should invest in the market through Mutual Funds. Yet, over the decade, a string of government owned mutual funds had failed to earn enough to pay the returns ‘assured’ to investors. Starting with the scam-hit Canstar scheme, most mutual funds had to be bailed out by their sponsor banks, or parent institutions. Then came the big bail out of Unit trust of India. Since UTI set up under its own act, it was the tax- payers who paid for the Rs 4800 crores bailout in 1999. Just three years later, it was back buying recklessly into the Ketan Parekh manipulated scrips and suffered big losses in the process. The record of the private mutual funds has also been patchy – after hitting a purple patch in 1999-2000, many of the sector specific funds were down in the dumps. It will be a long time indeed before small investors consider mutual funds a reasonably safe investment.

The 1998 Collapse :-In 1998, Harshad Mehta, Scamster of 1992,made a comeback by floating a website and writing columns in several newspapers giving tips on stocks. The result was the collapse of BPL, Videocon and Sterlite shares. This led to illegal opening of the trading system in the middle of the night by BSE officials to cover up this issue.

Ketan Parekh's Case (1999-2000) :- Ketan Parekh, a Mumbai based stock broker had large borrowings from Global Trust Bank during its Merger with United Trust of India Bank. He got a loan of about Rs.250 Crores from Global Trust Bank's Chairman Mr. Ramesh Gelli who was asked to quit later. This rigged the scrips of Global Trust Bank, Zee Telefilms, HFCL, etc. The prices of the selective shares constantly increased due to rigging .The investors who bought the share at higher prices thought that the market prices were genuine. Soon after the discovery of the scam of 1999-2000, the price of the stocks came down to the fraction of value at which they were purchased. The investors lost heavily. Even the banks faced a tremendous loss. Ketan Parekh was arrested in the year 2002.

The case of home trade (2000) :-This Company was launched in the year 2000 with Rs.24 crores of advertising campaign roping celebrities like Hrithik Roshan, Sachin Tendulkar and Shahrukh Khan. Eight Co-operative banks like Valsad People Co-operative bank, Navasari Co-operative bank from Gujarat lost around Rs.80 Crores due to bad investments by home trade. This was linked to Rs.82 lakh forgery in a Central Government Undertaking Employee Providend Fund Scheme. Mr.Sunil Kedar, Chairman of Nagpur district Central Co-operative Bank was arrested for bending the rules to invest in government securities and preparing false documents.Mr.Sanjay Aggarwal,Chief Executive of Home trade was initially missing but later surrendered in Nagpur.

DSQ Software Scam(2001) :-Mr.Dinesh Dalmia, Managing Director of DSQ Software was accused of dubious acquisitions and biased allotment in the year 2000 and 2001.The amount involved in the Scam was Rs.595 Crores. Dalmia was arrested in the year 2006.

SatyamComputers Case (2008) :-Mr.Ramalinga Raju, the former Chairman and Chief Executive had admitted that he had manipulated the balance sheet for several years to show huge inflated profits and fictitious assets. The estimated fraud was Rs.700 Crore billion, one of the highest committed frauds since 1996. Mr. Ramalinga Raju is in Jail for committing fraud, cheatingand forgery. The article dated Feb 17th,Dec 2008 by Devanshu Dutta in the Newspaper, quotes as follows-"The man who nailed the Bombay Scam 1864 was Khurshed. F. Nariman who has the Honour of point and a road named after him". Will this quote prove its stance in the near future?

5 Prevention of financial frauds

There are a few financial fraud prevention steps investors can take to attempt to prevent becoming victims of this type of financial fraud.

Step 1: Make sure you understand your investment strategy.

1) Lack of transparency is one of the biggest risks of investing in investment vehicles that you do not understand. For many investment strategies, it is often difficult to know exactly how or even where your money is invested
2) Asked in 2001 by a reporter from Barron's magazine how his "split-strike conversion" strategy managed to avoid ever having a down year in over a decade, Madoff said: "It's a proprietary strategy. I can't go into it in great detail."
3) If your advisor cannot, or will not, clearly and concisely explain the strategy guiding the management of your life savings, don't invest.

Step 2: Have an independent custodian.

1) We also suggest having an independent custodian who will send you monthly or quarterly statements as a regular third-party verification of asset security.
2) Audits can maximize financial fraud prevention by verifying a money manager's financial statements, as well as confirm that reported investments are held and trades actually made. Madoff sidestepped this by hiring a largely unknown accounting firm, reportedly controlled by his brother-in-law, to conduct annual audits.

Step 3: Invest in common stock or mutual funds with ticker symbols.

1) Stocks and mutual funds have ticker symbols through which valuations can be determined quickly and easily. More complex securities like mortgage-backed securities, derivatives, and private placements are complex to evaluate and price and can be sources of abuse.
2) It is noteworthy that many of the failed ponzi schemes and frauds that were uncovered during the crisis (Madoff, Stanford, Phillip Barry) were in investment products other than registered investment companies, known as mutual funds. Investors in these schemes did not have the same safeguards in place that provide protection to investor of registered mutual funds.
3) Unlike a hedge fund, a mutual fund is one of the most highly regulated investment products. The mutual fund itself is registered with the SEC as an investment company under the Investment Company Act of 1940. A mutual fund can only be advised by an investment advisor registered with the SEC pursuant to the Investment Advisors Act of 1940. The shares of a mutual fund are generally securities themselves registered with the SEC pursuant to the Securities Act of 1933 and regulated per the Securities and Exchange Act of 1934.
4) By investing in mutual funds, you and your advisor are able to view timely reports detailing the performance and holdings of the fund.
5) Financial fraud prevention is attainable if you are aware of the red flags. The best solution to financial fraud prevention is if its too good to be true, it probably is!

6 Conclusion remarks

Despite the issue of Indian companies being family owned, accounting fraud in India has nothing new about it, except perhaps the ways in which it has been perpetrated. The latest cases of accounting fraud seem to involve aspects of stock based incentive and mark-to-market accounting. However, the techniques to curb fraud must continue to involve tracking down all people who hold stakes in the business- those who stand to gain in case there is an inflated opinion about the performance. As for the regulations themselves, it is perhaps not necessary to bring in new regulations by the dozen- it is more important to understand the mindset of the Indian fraudster, bring in meaningful regulations that are not aped versions of their US and European legal counterparts, to administer and implement them more effectively and to understand that technology can both help and hurt our case, as we take our battle against accounting fraud to the next level.

DECLARATION

I hereby declare that the paper is an original contribution.

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